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No. 108

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1957

COMMISSIONER OF INTERNAL REVENUE, ET AL., Petitioners

vs

P. G. LAKE, INC., ET AL., Respondents

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR REHEARING

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COMMERCIAL RECORDER, FORT WORTH, TEXAS—5-6-58—70.

INDEX

	Page
Introduction	1
Errors Discussed:	
A. As to Weed Case	2
B. As to Fleming-Walsh Exchanges	3
C. As to Capital Gain Issue	4-13
I. Administrative Practice	4
II. Tax Rates and Classification	9
III. As to Depletion	11
D. As to Application of Section 112(b)(1)	13
Conclusion	14
Certificate	17

CITATIONS

Cases:	Page
Blair v. Commissioner, 300 U. S. 5	9
Commissioner v. Slagter, 238 F 2d 901	4,11
Commissioner v. Southwest Exploration Company, 305 U. S. 308	12,13
Harrison v. Schaffner, 312 U. S. 579, 583	9,10
Hawn v. Commissioner, 231 F 2d 340	11
Helvering v. Horst, 311 U. S. 112	9
Helvering v. Twin Bell Oil Syndicate, 293 U. S. 312	12
Lum v. Commissioner, 147 F 2d 340	11
Majestic Oil Corporation v. Commissioner, 42 B T A 659	7
McAllister v. Commissioner, 157 F 2d 235	11
Nail, R. E., v. Commissioner, 27 B T A 33	6
Ortiz Oil Company v. Commissioner, 37 B T A 656, 102 F 2d 508, cert denied 308 U S 566	7
Palmer v. Bender, 302 U. S. 63-69	3,12
United States v. Leslie Salt Co., 350 U S 383	8
Statutes and Rulings:	
Internal Revenue Code of 1939:	
Sec 23(m)	12
Sec 44	2
Sec 62	8
Sec 114(b)(3)	12
Sec 117	14
Treasury Rulings:	
G C M 22,730, C. B. 1941-1, p 214	5
G C M 24,849, C. B. 1946-1, p. 66	5,6,7,15
I. T. 3595	6
I. T. 4003, C. B. 1950-1, p. 10	7,8
I. T. 4093, C. B. 1952-2, p. 30	13
Revenue Ruling 55-749, C B 1955-2, p. 295	14

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PETITION FOR REHEARING

The respondents in the above styled and numbered cause, acting through their attorneys of record, hereby respectfully petition this Court to rehear this cause and, upon such rehearing, to affirm the decisions of the Court below; or to remand these causes with instructions as hereinafter outlined, or clarify and cor-

rect the holdings of this Court in the respects hereinafter specified. The opinion of this Court was delivered on April 14, 1958.

The errors in this Court's said opinion and holdings are as follows:

A. *As To The Weed Case*

The tax years before the Court were the calendar years 1948 and 1949 (R. 252). The assignment of the sulphur payment involved was made in the year 1947, and the taxpayers reported the transaction as an installment capital gain sale in their 1947 income tax return, in which year they received the installment obligation (R. 256-258). Section 44 (b) of the Internal Revenue Code of 1939, dealing with sales on the installment basis, applies only to sales of real *property* and casual sales of personal property. It should be noted that Section 44 is applicable only to sales of "property", just as Section 117 provides for capital gain treatment on the sale of "property". If, as this Court holds, the sale of a carved out oil (or sulphur) payment is not a sale of "property", but an assignment of future income, then clearly such a sale would not be of "property" within the meaning of Section 44(b) and installment treatment would not be permitted. In such a case Weed, under this Court's decision, would be taxed in full in the year of the sale (1947) which year is not before the Court.

It is inconceivable that this Court intended to hold that "future income" could be sold on the installment basis. If this Court finally so holds, then an attorney who is entitled to collect a large fee in one year could sell his right to that fee on the installment basis and report his gain therefrom over any number of years. If, as this Court apparently held, Weed sold future income, then he made the sale in 1947, and the entire deficiency asserted against him in 1948 and 1949, the only years before the Court, should be expunged; and this Court should so direct.

B. *As To The Fleming-Walsh Exchanges Of Oil Payments For Real Estate*

In reversing the Court below on its holding that no gain or loss was to be recognized from the Fleming-Walsh exchanges, this Court said:

> "As we have seen, these oil payment assignments were merely arrangements for *delayed* cash payment of the purchase price of real estate, plus interest." (Emphasis supplied).

The acquisition of real estate for a "delayed cash payment" cannot produce taxable income. This Court has held (*Palmer v. Bender*, 302 U.S. 63-69):

> "It follows that one does not subject himself to income tax by the mere purchase of property, even if at less than its true value, and that taxable gain does not accrue to him before he sells or otherwise disposes of it."

It necessarily follows that the only income received by the Flemings and Walsh in the years before the Court (1948 and 1949) was the amount produced in those years by the oil payments which they assigned for the lands. These amounts are shown in the Record—pages 146-147, 154, and the income taxable to this group of respondents should be limited to these amounts—less appropriate allowances for depletion—if the Court's holding on the basic question is to be upheld. (See, in this connection, *Commissioner v. Slagter*, 238 F 2d 901, CA 7, 1956).

It is feared that further controversy will result below if this Court does not clearly indicate the application which it intended be given to the above quoted statement. Further, the reversal directed by this Court appears to be a reversal of the judgment of the United States Court of Appeals for the Fifth Circuit, and, if so, this would leave the holding of the Tax Court in the Fleming and Walsh cases intact. The Court's intention in this respect should be clarified.

C. *The Holding of the Court that the Several Transactions Involved Produced Ordinary Depletable Income, and Not Long Term Capital Gain, Was Erroneous For The Following Reasons:*

1. **As To Administrative Practice**

Recognizing that until 1946 the Treasury practice agreed with the contention of the taxpayers in these

cases that the assignment of a carved-out oil payment right was productive of long-term capital gain, the Court then incorrectly stated (footnote 5 of the Court's opinion) that "The pre-1946 (i.e. before the promulgation of G M C 24,849) administrative practice was not reflected in any published ruling or regulation. It, therefore, will not be presumed to have been known to Congress or incorporated into the law by re-enactment." This statement is incorrect because in G C M 22,730, 1941-1, p. 214, published, as the citation indicates, in 1941, it was expressly held that the carving out and sale of an oil payment for cash was a sale, requiring the assignor to compute gain or loss by allocating against the consideration a portion of his basis in the property, if he had not pledged the proceeds to the development of the property. This ruling was reproduced in full in the Lake-Fleming brief, pp. 88-112. The precise holdings referred to are found there at pages 96 and 111.[1] This G C M 22,730 was a carefully considered analysis and restatement of the Treasury's practices and holdings with respect to many types of transactions with respect to oil properties.

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[1] "A cash payment made upon the execution of an instrument stipulating only for oil payments is, therefore, regarded not as an advance royalty payment but as proceeds from a sale in which the payee disposed of his economic interest in oil or mineral in place, less the fraction thereof represented by the oil payment rights reserved by him."

"In that event, however, the transaction would not have been only an investment of the stated sum by F but a sale of an oil payment interest by D, and the latter would have been required to allocate thereto a part of his basis and compute gain or loss."

G C M 24,849, C. B. 1946-1, p. 66, gave notice to Congress that the administrative practice was to treat the carving out and disposition of long-lived oil payments as sales. This ruling was limited to "short lived" oil payments, which "ordinarily pay out and expire within one or two years". This plainly indicated what the previous practice had been as to all carved-out oil payments and that no change was being attempted in the previous treatment of long-lived oil payments. The fact that G. C. M. 24,849 was intended to apply only to short-lived oil payments, as that term is there defined, is reenforced by I. T. 3895, promulgated early in 1938; which again made reference to "short-lived" oil payments. (See Fleming-Walsh brief, page 124.)

That this was the known policy of the Treasury Department is also evidenced by the Treasury's acquiesence in *R. E. Nail*, 27 B T A 33, decided in 1932. There, as to a donative assignment of an oil payment out of a larger interest, the Board of Tax Appeals held that the transaction was not an anticipatory assignment of income from property, but was a completed transfer of a present interest in property. The Court held that the donative assignment of income cases were inapplicable. The acquiesence of this decision was published in C B XII-1, p. 9, and this acquiesence remained extant until withdrawn in 1949, when it was ruled that the donation of short-lived oil payments carved out of larger interests was the assignment of future income. This 1949 ruling was made prospectively only (I T 3935, 1949-1, C. B.

1939). Likewise, in *Ortiz Oil Company v. Commissioner*, 37 B T A 656 (1938), affirmed 102 F 2d 508, C C A 5, 1939, certiorari denied 308 U S 566, and again in *Majestic Oil Corporation v. Commissioner*, 42 B T A 659 (1940), the Government affirmatively argued that the sale of a carved out oil payment was not the sale of income from the property, but was the sale of an economic interest of oil in place, resulting in taxable gain to the seller. It was also the position of the Government that the cash received was *not* ordinary income and the seller was *not* entitled to depletion with respect to such payment. This policy urged upon the Courts by the Government was accepted by the Courts. Again this policy was publicized by the published acquiesence in the Majestic case, C. B. 1940-2, p. 5.

Not one of the oil payments involved in these proceedings was "short lived" within the meaning given that term in G. C. M. 24,849. All had lives of more than three years, and the four Fleming payments had lives varying from five years and eight months to twelve years. (Petitioners brief, pp. 6, 11 and 12).

All transactions, except the Lake, occurred before 1950, when I. T. 4003, C. B. 1950-1, p. 10, announcing the Commissioner's present theory was promulgated.

The Commissioner has no special regulatory power as to the capital gain sections of the 1939 code. His

regulatory power here is limited to enforcement. Sec. 62 I R C of 1939.

Congress approved the long-term capital gain treatment of carved-out oil payments by reenacting, without pertinent changes, the capital gain sections of earlier Acts in the Internal Revenue Code of 1939, and by leaving these provisions unchanged in the many subsequent amendatory Acts, and in the Internal Revenue Code of 1954.

The 1950 ruling of the Commissioner (I T 4003, C. B. 1950-1, p. 10) upheld by this Court in reversing these cases, is retroactive legislation, contrary to *United States v. Leslie Salt Company*, 350 U.S. 383. Under the same authority, the Commissioner was powerless to change, as to transactions occurring after I. T. 4003 was issued, his previous interpretation which had been approved by Congress.

Neither the petitioners nor this Court denies, nor can deny, that the transactions under consideration come within the literal language of the capital gain section. To permit the Commissioner to say that, today, a certain transaction is the sale of a capital asset and, tomorrow, it is not, is not the exercise of an administrator's rule-making power, but the improper exercise of legislative power. The so-called ascertainment of the intention of Congress, made 25 or more years after Congress acted, with the conclusion directly contrary to that previously reached by the Commissioner many years nearer the action is wholly unconvincing; all the more so, when the only Congressional expression, other than the plain words of the statute, evidenced a desire to encourage sale of "mineral" and other properties.

II. Tax Rates and The Classification of Subjects of Taxation Are For Congress

On the question of whether a particular sales transaction bears a 25% rate or a 91% rate, the answer should be found in the plain language of the Statute and not on some nebulous theory, such as the doctrine of the Horst case (*Helvering v. Horst*, 311 U.S. 112), drawn by this Court from an alien area of the tax laws. The Horst case, itself, on the donative assignment of income area has its limitation, as evidenced by the decision of this Court in *Blair v. Commissioner*, 300 U.S. 5. The difficulty in drawing the line between cases like Horst and that like Blair was recognized by the Court itself in *Harrison v. Schaffner*, 312 U. S. 579, 583, where the Court said:

> "* * * we leave it to future judicial decisions to determine precisely where the line shall be drawn between gifts of income-producing property and gifts of income from property of which the donor remains the owner, for all substantial and practical purposes."

Since income tax law—nor less than criminal law—should be clear and certain, it is respectfully submitted that it was error for this Court to extend this uncertain and nebulous principle into the capital gain area.

And even if the nebulous and uncertain Horst principle is to be written into Section 117, it is clear that the Court went too far in holding that all carved out

oil payments, irrespective of life—including the 12-year oil payment in the Fleming case—are to be treated simply as anticipations of future income under the Horst doctrine. If the Horst doctrine is to be written into Section 117, it seems obvious that, while there may be some significance attaching to the retention of an interest in the property, if the oil payment sold is insubstantial in relation to the reversionary interest kept, the retention of an interest has no relevancy whatever if the opposite is true and the oil payment interest be substantial and the reversionary interest remote or unsubstantial. If a taxpayer owning an oil property with a twenty year life should sell a two or three year oil payment and keep the residue of his property, then it might be contended as a practical matter, under an extension of the Horst doctrine, that the seller is simply enjoying or anticipating fruits flowing from a continued ownership of the property. But if, as in the Fleming case, he sells a twelve year oil payment, and his reversionary interest is remote or insubstantial in relation to what he sold, it cannot be said that he has simply anticipated income and has retained the corpus that produces such income. It cannot be said that the really small amount retained is the corpus and the very large interest sold is the income. It cannot be said, as in the Horst case, that he is simply enjoying the benefits of continued ownership of property. Thus, if the Horst principle is to be applied to carved out oil payments, the rule quoted above in *Harrison v. Schaffner* must be applied. This rule has been recognized frequently by the Courts. See *McAllister v.*

Commissioner, 157 F 2d 235; *Haven v. Commissioner*, 231 F 2d 349 (C A 5); *Lum v. Commissioner*, 147 F 2d 356 (C A 3).

If the Horst doctrine is to be applied in this area, then it is incumbent upon the Court to remand these cases and afford the parties and the trial court an opportunity to develop the facts necessary to an application of the broad principle which this Court should clearly enunciate. These principles should be so delineated as to enable the trier of the fact to draw the line, as this Court stated in the *Schaffner* case supra, between "gifts of income producing property and gifts of income from property of which the donor remains the owner for all substantial and practical purposes."

III. As to Depletion

The grantee in an oil payment conveyance acquires a depletable economic interest in the property from which the interest came because such grantee can look

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Petitioners' reply brief (which was not made available to respondents' attorneys until the day this case was argued) attempts to deal with this "double depletion" question. See Point 4, pp. 9-11. The statement there made that the oil payment grantee does not acquire a depletable economic interest but recovers his investment by amortization, in addition to being a mere play on words, is contrary to the continuous Treasury practice (which is, and always has been, to allow any oil payment holder a deduction for depletion) and to the decisions of all of the Courts, except perhaps, that of the 7th Circuit in *Commissioner v. Slagter*, 238 F 2d 901. It is also contrary to the position taken in petitioner's original brief in footnote 17, page 38, and is di-

only to oil (or gas) when, as and if produced for the return of his investment. Under all of the holdings of this Court from *Palmer v. Bender*, 287 U S 551 (1933) through *Commissioner v. Southwest Exploration Company*, 350 U S 308 (1957) this is all that is necessary to permit and require the grantee to look only to the depletion allowance for the recovery of his investment.

The controlling statutory provisions, *Sections 23 (m) and 114(b)(3)*, Internal Revenue Code of 1939 (Appendix A, pp. 72, 73, 74 Lake and Fleming brief) provide as to any oil or gas property for a single depletion allowance to be apportioned among all of those who have economic rights in the property. See also *Helvering v. Twin Bell Oil Syndicate*, 293 U.S. 312.

This Court has held that any method which permits two parties to have a depletion allowance with respect to the same amount of oil production is erroneous. *Helvering v. Twin Bell Oil Syndicate*, 293 U.S. 312.

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rectly contrary to the basic rule of *Palmer v. Bender*, 287 US 551-557 that "the language of the statute (regarding depletion) is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship income derived from the extraction of oil, to which he must look for a return of his capital." Any contrary holding reverses a dozen or more decisions of this Court and the continuous practice of the Treasury—both of which have been repeatedly approved by Congress through repeated reenactment.

Since depletion cannot be denied the grantee of an oil payment interest with respect to the oil applicable to such oil payment, the holding of this Court that the grantor of such an oil payment interest is entitled to depletion measured by the consideration received necessarily result in the prohibted double depletion allowance.*

D. *The Court Erred in Holding Section 112(b)(1) Internal Revenue Code of 1939 Inapplicable to the Fleming Exchanges.*

The Flemings and Walsh clearly had capital investments in their several holdings. These investments were not "liquidated" when they received lands in exchange for a portion of these capital investments. The pertinent definition of "liquidate" is "to convert into cash." Certainly this was not done. The investment continued without liquidation. Since these respondents parted with "interests in land" in exchange for lands, the requirement of the statute and regulations for non-recognition of gain have been met. The Commissioner's interpretations (See I. T. 4093, C. B. 1952-2, p. 30, holding Section 112(b)(1)

* There is no difference, important here, between the carved-out net profit interest dealt with in the *Southwest Exploration* case, 350 US 308, and the carved-out oil payments involved here. The holding of this Court that the grantee of the carved-out net profit interest in the Southwest case was entitled to the depletion allowance on the income applicable to such interest and that the grantor was not, illustrates both phases of the depletion rule which this Court violated in its opinion in this instant case.

applicable to the exchange of an oil lease for lands —

The only thing of value attaching to the oil lease involved in this ruling was the right to oil and gas when produced. This is as much "future income" as is the oil and gas applicable to an oil payment.

Fleming and Lake brief, p. 127, and likewise applicable to the exchange of water rights for land, Rev. Ruling 55-749, 1955 C. B.-2, p. 295, Fleming-Lake brief p. 131) reenforce this.

Conclusion

The transactions here under consideration are not "devices" either "artful" or "transparent" as the Court characterized them. Each was a bona fide business transaction entered into in reliance on long-continued Treasury practice, expressly approved by the Courts and, through re-enactment of the applicable statutory provisions, by Congress. Nor would the affirmance of the holdings below open the door of the Treasury vaults to oil operators. Any operator who makes a practice of selling carved-out oil payments is, by the express terms of *Section 117, I R C of 1939*, a dealer, just as is a real estate subdivider, and is taxable on gains therefrom as ordinary income, *without any allowance for depletion*. As the petition for certiorari shows, the petitioners were able to locate only some 43 cases involving the question. This necessarily covers the 1946-1957 period, where hundreds of thousands of oil operators reported as to multiplied hundreds of thousands of oil properties. Against this factual background, the number of pending cases

and the amounts of taxes involved, *as asserted* by the petitioners, are trival.

If, as it should not be, the effect of the holding on tax revenues is an appropriate consideration, it should be remembered that every tax rule cuts both ways; and that, since G. C. M. 24,849 was promulgated, it has frequently been availed of to decrease taxes by avoiding the application of the limitation on the percentage depletion allowance and thereby increasing tax-free allowable percentage depletion.* It is con-

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* The allowance for percentage depletion as to an oil and gas property is 27-1/2% of gross income but not more than 50% of net income calculated before depletion. Section 114 (b)(3) I R C of 1939 (Lake-Fleming brief pp. 78-79). The method of increasing percentage depletion available under G C M 24,849 and this Court's opinion is easiest illustrated by a hypothetical situation in which a property is developed in one year and intangible drilling costs are expensed, as expressly premitted by statute. Two years, with and without the use of a carved-out oil payment producing depletable income will be used.

	Without Oil Payment		With sale in 1st year of 1 year oil payment yielding $200,000	
	1st Year	2nd Year	1st Year	2nd Year
Gross Income	250,000	500,000	450,000	300,000
Dev. Expense	150,000	None	150,000	None
Operating Exp.	75,000	125,000	75,000	125,000
Net Income before Depletion	25,000	375,000	225,000	175,000
Depletion	12,500	137,500	112,500	82,500
Taxable Income	12,500	237,500	112,500	82,500

fidentally asserted that, tax-revenue wise, this is much more important than would be the allowance of capital gain with respect to carved-out oil payment sales.

These cases should not be decided upon the basis of the effect of the decision on revenues, nor by attributing to Congress—more than three decades after its original action in 1921—an intention contrary to the plain meaning of the language used, and the intention expressed in the reports of its Committees.

Wherefore, respondents respectfully pray that this petition be granted.

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The assumed production in the second year is larger than the first because all wells would be operated for the full year. Increase in depletion allowances by "artful" use of this Court's holding, $45,000—with corresponding decrease in taxable income.

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Harry C. Weeks, attorney of record for respondents, P. G. Lake, Inc. and Wm. Fleming et al., hereby certifies that the foregoing petition for rehearing is presented in good faith and not for delay.

Harry C. Weeks